

STATE OF NEW YORK

DIVISION OF TAX APPEALS

In the Matter of the Petition	:	
of	:	
TASO'S VIDEO FAIR, INC.	:	DETERMINATION
	:	DTA NO. 808603
for Revision of a Determination or for Refund	:	
of Sales and Use Taxes under Articles 28 and 29	:	
of the Tax Law for the Period September 1, 1985	:	
through August 31, 1988.	:	

Petitioner, Taso's Video Fair, Inc., 8915 Fifth Avenue, Brooklyn, New York 11209, filed a petition for revision of a determination or for refund of sales and use taxes under Articles 28 and 29 of the Tax Law for the period September 1, 1985 through August 31, 1988.

A hearing was commenced before Timothy J. Alston, Administrative Law Judge, at the offices of the Division of Tax Appeals, Riverfront Professional Tower, 500 Federal Street, Troy, New York, on February 24, 1993 at 1:15 P.M. and was continued to conclusion on April 29, 1993 at 1:30 P.M. Petitioner filed a memorandum on June 11, 1993. The Division of Taxation filed a letter brief on July 9, 1993. Petitioner filed a letter in reply on July 26, 1993. Petitioner appeared by Stephen P. Sophir, Esq. The Division of Taxation appeared by William F. Collins, Esq. (Michael B. Infantino, Esq., of counsel).

ISSUES

I. Whether the Division of Taxation properly utilized an indirect audit method and, if so, whether petitioner has shown error in either the audit method or the audit result.

II. Whether petitioner has shown reasonable cause and an absence of willful neglect to warrant cancellation of penalties imposed herein.

FINDINGS OF FACT

On May 30, 1989, following an audit, the Division of Taxation ("Division") issued to petitioner, Taso's Video Fair, Inc., a Notice of Determination and Demand for Payment of Sales and Use Taxes Due which assessed \$53,871.76 in total tax due, plus penalty and interest, for the period September 1, 1985 through August 31, 1988.

Petitioner operates a video rental store. During the period at issue, petitioner's store was located at 8623 Fifth Avenue, Brooklyn, New York. Petitioner's store was open seven days per week from 10:00 A.M. until 9:00 P.M. (Fridays and Saturdays until 10:00 P.M.)

During the relevant period, petitioner had two officers and shareholders. Anthony Kanellopoulos was president and owned 36% of the corporate stock. His brother, Peter Kanellopoulos, was vice-president and owned 64% of the stock. Prior to about September or October 1986, Anthony Kanellopoulos was involved in the daily management of the store. After that time, Anthony Kanellopoulos discontinued his day-to-day involvement and turned such duties over to Peter Kanellopoulos. At some point in 1987, Anthony Kanellopoulos became aware that his brother had a psychiatric illness and a substance abuse problem for which he received treatment, which included several weeks of in-patient care. While he was ill, Peter Kanellopoulos was unable to effectively manage the video store.

In order to rent a video in petitioner's store, a customer had to become a "member". The regular cost of a membership was \$9.95. Petitioner also ran coupon and gift certificate specials providing free memberships to

customers. The cost of a video rental ranged from \$1.00 per day to \$2.50 per day. Customer purchases of memberships and video rentals were rung up on petitioner's cash register. New releases were rented at \$2.50 for the first day and \$1.00 per day thereafter. New releases were the most popular with customers. Petitioner had an inventory of 2,500 to 3,000 tapes in the store during the period at issue. Petitioner also sold blank video tapes and rented video game cartridges.

Throughout the audit period petitioner consistently ran promotions through direct mail advertising and newspaper advertising. Such promotions often offered free memberships or "2-for-1" rentals.

The procedure by which a customer rented a video from petitioner was as follows: the customer selected a video; petitioner's employee recorded the selection in the customer's file; the customer subsequently returned the video and paid the charge; petitioner's employee recorded the return of the video in the customer's file.

When an individual became a "member", petitioner created a file which contained a rental activity sheet for that member. Petitioner used such files to record the member's selections and thereby track its inventory. Petitioner maintained in the membership file only the most recent rental activity sheet for each individual member in order to track inventory and to verify the member's signature. Petitioner did not maintain the complete set of its members' rental activity.

The rental activity sheets referred to above identified the video, listed the dates the video was rented and returned, the initials of the employee who checked the video "out" and "in", and the member's signature. For cash transactions, the activity sheets also listed, under the heading "amount due", the number of days the video was out. For non-cash

transactions, designations such as "coupon" or "free" were listed under this heading.

By letter dated September 7, 1988, the Division¹ requested petitioner's books and records pertaining to its sales tax liability for the period September 1, 1985 through August 31, 1988 as follows:

"All books and records pertaining to your Sales Tax Liability for the period under audit should be available. Required documents include Sales tax returns and accompanying workpapers, detailed sales book(s), sales journals, all sales invoices, documents supporting the nontaxable status of all untaxed sales (i.e. resale certificates, diplomatic and exempt certificates, shipping records), ledgers, cash register tapes and any type of memoranda prepared for consignment sales. Federal tax returns and New York State WRS-2 wage reporting forms should also be made available. Additional information may be required during the course of the audit."

Subsequent to this request, the Division was advised by petitioner's former representative, a Mr. Visci, that petitioner did not maintain sales invoices or cash register tapes during the audit period.

In the absence of sales invoices or cash register tapes, the Division determined petitioner's taxable sales using an estimated audit method whereby the Division utilized petitioner's cash register tape summary readings for four days to determine petitioner's average daily rentals. In its audit the Division presumed that the register tapes represented video rentals only. Specifically, the Division reviewed petitioner's cash register tapes for October 29, 1988 (Saturday), October 30, 1988 (Sunday), February 27, 1989 (Monday) and February 28, 1989 (Tuesday) and determined sales for these four days as follows:

<u>Date</u>	<u>Total Sales</u>
October 29, 1988	\$ 721.64
October 30, 1988	635.04
February 27, 1989	464.24
February 28, 1989	<u>404.52</u>
Total	\$2,225.44

The Division did not submit copies of the cash register tapes used in its calculation of

¹The audit herein was conducted by an auditor employed by the Audit Division of the City of New York Finance Department.

the assessment herein. The Division's audit report indicates that the Division used petitioner's machine reading numbers as follows: October 29: Z5617, Z5618, Z5619; October 30: Z5824, Z5825, Z5826; February 27: Z75530, Z75532; February 28: Z75667, Z75669. The audit report further indicated that the readings so used were encaptioned "Dept", "Clrk" and "Trans" reports.

The Division next calculated the mean or average daily rentals figure for these four days which equaled \$556.36. This average daily rental figure was then multiplied by the number of days the store was open during the period June 1, 1987 through August 31, 1988, i.e., the five most recent quarters of the audit period, to reach video rentals totaling \$253,143.80 for this period.

While present in petitioner's store, the Division also reviewed petitioner's records of members. Such review revealed that petitioner gained 3,820 members during the entire audit period. Using petitioner's regular fee for a membership of \$9.95, the Division thus determined \$38,009.00 in membership fees for the entire audit period. The Division then determined a membership fee per quarter figure for the audit period (\$38,009.00 divided by 12) and multiplied this per quarter figure by five to

reach a membership fee figure of \$15,837.10 for the five quarters comprising the period June 1, 1987 through August 31, 1988.

The audited video rental amount and membership fee amount for the June 1, 1987 through August 31, 1988 period were totaled and then divided by gross sales reported for the same period. The resulting margin of error of 1.2143 was applied to petitioner's taxable sales reported throughout the audit period to reach additional taxable sales for the audit period of \$652,991.04. The Division then applied the prevailing sales tax rate of 8.25% to reach additional tax asserted due herein of \$53,871.76.

Also during the course of the audit, the Division compared petitioner's reported gross sales during the audit period as indicated by its sales tax returns, its bank deposits² and its Federal income tax returns. This comparison indicated that for the period February 1, 1986 through August 31, 1988 petitioner's bank deposits exceeded petitioner's reported gross sales per its sales tax returns by \$117,602.00. Additionally, for the years 1986 and 1987³, petitioner's gross sales as indicated by its Federal income tax returns exceeded gross sales as indicated by its sales tax returns by \$72,754.00.

During the course of the audit, the auditor did not specifically ask to review petitioner's membership files, nor were such files made available to the auditor during the course of the audit.

Petitioner submitted into the record a sample of its member activity sheets as described above. With a few exceptions where the sheets bore a date within the audit period, it cannot be determined whether such sheets documented rental activity during the audit period. Petitioner conceded that the sample included activity sheets from outside the audit period.

²Petitioner provided the Division with copies of its bank statements during the course of the audit.

³As indicated in the auditor's workpapers, "1986" included February 1, 1986 through January 31, 1987, and "1987" included February 1, 1987 through January 31, 1988.

Petitioner submitted into the record a plastic bag of coupons which purportedly had been used by customers to rent videos subsequent to the audit period. Anthony Kanellopoulos testified that it was petitioner's practice to ring up all sales (including coupon sales) as cash and to charge the customer the difference between the total rung up and the value of the coupon. Mr. Kanellopoulos further testified that it was petitioner's procedure that the coupons submitted by the customer were marked with the customer's membership number and the value of the coupon. A review of the coupons submitted reveals that very few have any such markings thereon.

During the audit period petitioner did not retain its cash register tapes or coupons. Mr. Kanellopoulos testified that such tapes were discarded because they did not accurately reflect the amount of cash taken in by petitioner. Mr. Kanellopoulos testified that a summary or "Z" reading was taken from petitioner's register each day and that such reading was reconciled each day to the amount of cash and coupons taken in. Mr. Kanellopoulos further testified that such daily reconciliation sheets were destroyed on an approximately monthly basis. Additionally, Mr. Kanellopoulos testified that all cash receipts were deposited in petitioner's bank account with the exception, during 1988, of petitioner's payroll which was paid in cash.

Petitioner submitted into the record a Video Retailer Survey 1989 published by Video Store Magazine. Included in this survey were the following statistics regarding weekly rental activity of retail video stores: Sunday 11%; Monday 9%; Tuesday 8%; Wednesday 8%; Thursday 8%, Friday 22%; Saturday 34%. This statistical information was based on responses of 378 video retailers from 44 states.

Petitioner introduced into the record copies of daily summary cash register readings for the months of October 1988 and February 1989, together with copies of what were assertedly daily reconciliation sheets by which petitioner reconciled the tapes to its actual cash receipts. No documents, i.e., coupons, were submitted to verify the reconciliations and no information contained on the tapes supported petitioner's reconciliations. The tapes themselves list, under the heading "Dept Reprt", various categories of purchases such as "rental", "ad. day", "member", and "access" along with the number and total amount of purchases in each such category. By dividing the total amount of purchases in each category by the number of such purchases reveals purchase prices as follows: "rental" \$2.50; "ad. day" \$1.00; "member" \$9.95. The tapes submitted by petitioner contain no sales tax category. Also, based on the purchase prices (indicated above), it does not appear that the total amount of purchases on the tapes submitted included sales tax.

Among the cash register summary readings submitted by petitioner were the following:

<u>Date</u> ⁴	Machine Reading #	Total Sales Indicated on <u>Tape</u>
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The dates as listed on the register tapes submitted by petitioner are somewhat confusing. The Division indicated that the tapes used in the audit were from October 29 and 30, 1988 and February 27 and 28, 1989. The dates listed on these four machine readings, which were in fact used by the Division on audit (see, Finding of Fact "12"), would seem to indicate that the four-day observation period was actually October 30 and 31, 1988 and February 28 and March 1, 1989. This discrepancy would appear to have no impact, however, upon the audit results herein.

It should also be noted with respect to the dates listed on the tapes that all of the cash register tapes submitted by petitioner and the sample submitted by the Division indicated "87" as the year. This discrepancy was explained by Mr. Kanellopoulos as a failure to reprogram the register to reflect changes in the year. Given that the sample submitted by the Division and the

10/30/88	Z5617	\$666.64
10/31/88	Z5824	586.64
2/28/89	Z5530	464.24
3/1/89	Z5667	404.52

At the top of each tape, the date and time was listed. The time so listed was consistently in the 10:00 P.M. to 11:00 P.M. range.

The cash register summary tapes submitted by petitioner indicated a sales activity for the 31 days of October 1988 of \$13,275.04 and for the 28 days of February 1989 of \$10,875.24, with an average daily sales amount for the two months of \$409.33.

At hearing, petitioner introduced certain evidence indicating that, while it gained 3,864 memberships during the audit period as the Division asserted on audit, only 1,252 of such memberships were paid memberships. The balance of such memberships were "no charge" memberships. At hearing, the Division accepted petitioner's assertions regarding the number of paid memberships during the audit period.

CONCLUSIONS OF LAW

A. The law is well settled with regard to the Division's authority to conduct sales tax audits using indirect audit methodologies. The Tax Appeals Tribunal stated the relevant standard in Matter of Marine Midland Bank, N.A. (Tax Appeals Tribunal, May 13, 1993), as follows:

"[b]ecause the statutory authority to determine a taxpayer's sales tax liability by estimate procedures rests upon a finding that the taxpayer's books and records are inadequate to conduct a complete audit, the Division is required to first request (Matter of Christ Cella v. State Tax Commission, 102 AD2d 352, 477 NYS2d 858, 859) and thoroughly examine (Matter of King Crab Rest. v. Chu, 134 AD2d 51, 522 NYS2d 978, 979-980) the taxpayer's books and records for the entire period of the proposed assessment (Matter of Adamides v. Chu, 134 AD2d 776, 521 NYS2d 826,828, lv denied, 71 NY2d 806, 530 NYS2d 109), in order to determine from verification drawn independently from within these records whether they are sufficient to support a complete audit (Matter of Meyer v. State Tax Commn., 61 AD2d 223, 402 NYS2d 74, 76, lv denied 44 NY2d 645, 406 NYS2d 1025). If the Division's examination establishes that the taxpayer's records are adequate and

four tapes listed above (which were used by the Division on audit) all indicated "87" as the year, petitioner's explanation of this discrepancy is accepted.

complete, the taxpayer is entitled to have its assessment calculated based upon a detailed audit of those records (Matter of Kennedy & Co. v. Chu, 125 AD2d 773, 509 NYS2d 199; Matter of Allied New York Servs. v. Tully, 83 AD2d 727, 442 NYS2d 624, Names in The News v. New York State Tax Commn., 75 AD2d 145, 429 NYS2d 755; Matter of Chartair, Inc. v. State Tax Commn., 65 AD2d 44, 411 NYS2d 41.)" (Matter of Marine Midland Bank, Tax Appeals Tribunal, May 13, 1993.)

B. The corollary to the foregoing, of course, is that, where the Division follows the required steps and thereby establishes the taxpayer's records to be inadequate and/or incomplete, the Division may resort to indirect methods of auditing, including the use of external indices, to estimate tax. (See, e.g., Matter of Petak's of New York, Tax Appeals Tribunal, September 9, 1993.) Where the Division resorts to such a method, it must select a method of audit reasonably calculated to reflect the tax due (Matter of Grecian Square v. State Tax Commn., 119 AD2d 948, 501 NYS2d 219, 221), and the burden is on petitioner to establish by clear and convincing evidence that both the method used to arrive at the tax assessment or the assessment itself is erroneous (Matter of Sol Wahba, Inc. v. State Tax Commn., 127 AD2d 943, 512 NYS2d 542, 543).

C. In this case, the Division's letter dated September 7, 1988 constituted an unequivocal request for petitioner's books and records for the entire audit period (see, Matter of Scholastic Specialty Corp., Tax Appeals Tribunal, September 10, 1992, confirmed ___ AD2d ___ [Nov. 18, 1993]; compare, Matter of Top Shelf Deli, Tax Appeals Tribunal, February 6, 1992). Following such request, the Division became aware that petitioner did not maintain cash register tapes or sales invoices. Clearly, under such circumstances, the Division's resort to an indirect audit methodology was proper.

D. As to the specific methodology utilized, it is well established that while the audit method selected must be "reasonably calculated to reflect the taxes due" (Club Marakesh v. Tax Commn. of the State of New York, 151 AD2d 908, 910, 542 NYS2d 881, 883 lv denied 74 NY2d 616, 550 NYS2d 276), such method need not be immune from attack as imprecise (see, Meskouris Bros. v. Chu, 139 AD2d 813, 814-815, 526 NYS2d 679, 681). "[W]here the taxpayer's own failure to maintain proper records prevents exactness in determination of sales

tax liability, exactness is not required" (Meyer v. State Tax Commn., supra, at 223, 228, 402 NYS2d at 78).

E. In the instant matter, the Division utilized four days of cash register tapes to determine petitioner's taxable sales for the audit period. Inasmuch as petitioner failed to maintain cash register tapes or other records for the period at issue sufficient to permit a detailed audit and inasmuch as there is a large body of case law upholding audit methods similar to that employed herein, it is concluded that such audit method must be sustained (see, e.g., Lombard v. Commr. of Taxation & Fin., ___ AD2d ___, 602 NYS2d 972 [one-day observation test]; Matter of Vebol Edibles v. Tax Appeals Tribunal, 162 AD2d 765, 557 NYS2d 678, lv denied 77 NY2d 803, 567 NYS2d 643 [two-day observation test]; Matter of Club Marakesh v. Tax Commn. of the State of New York, supra [one-day observation test]; Matter of Meskouris Bros. v. Chu, supra [two-day observation test]).

F. Petitioner contended that its books and records were sufficient for the purpose of verifying taxable sales and that the auditor failed to thoroughly review such records during the audit. This contention is rejected. The evidence in this case unequivocally establishes that petitioner's records were inadequate. Petitioner concedes that it did not maintain cash register tapes. Further, with respect to the membership files, the record herein indicates that such files contained, in summary form, a listing of video rentals by individual members, but that such files were incomplete. Specifically, petitioner retained only the most recent rental activity sheet (for the purpose of verifying the member's signature) and discarded all other such sheets (see, Finding of Fact "7"). Thus, even if the auditor had been advised of the contents of and had reviewed the membership files, the Division's right to resort to an estimated audit method would remain unaffected for such files were, by Mr. Kanellopoulos' own testimony, incomplete.

G. Petitioner also contended that the average daily sales figure resulting from the four-day observation period used on audit did not fairly represent petitioner's average daily sales. Specifically, petitioner argued that the days utilized in the Division's test (Saturday, Sunday, Monday and Tuesday) constituted petitioner's four busiest days of the week, and that the

observation period should be expanded to more accurately reflect petitioner's average daily sales.

In support of this argument, petitioner has submitted copies of cash register tapes summarizing its daily sales activity for the months of October 1988 and February 1989. While the Division has disputed the authenticity and accuracy of these tapes, upon review thereof it is concluded that the tapes submitted by petitioner do constitute an accurate summary of its sales activity for those two months. Contrary to the Division's auditor's assertion at hearing, the tapes submitted are clearly daily summary readings. Further, the Division itself relied on the same tapes in its audit (compare, Findings of Fact "12" and "23"). Accordingly, it is concluded that the use of the tapes submitted by petitioner will more accurately and reasonably reflect petitioner's average daily sales. The Division is therefore directed to recompute petitioner's audited average daily sales by totaling the daily sales figures set forth on the copies of cash register tape summaries submitted into evidence and dividing such figure by the total number of such days. Such computations should result in a revised average daily sales figure of \$409.33 (see, Finding of Fact "25").

H. Petitioner also maintained that the Division's audit method improperly failed to account for its use of coupons and other promotions. Petitioner did establish that it used coupons for free rentals and free memberships in its business. Petitioner failed, however, to show that the Division's calculations erroneously included free rentals and free memberships. Specifically, petitioner failed to prove its assertions that coupon sales were rung up as cash sales during the relevant period. Petitioner's failure to prove its contentions results from a lack of supporting documentation in the record.⁵ Petitioner presented no coupons for video rentals purporting to pertain to the audit period. Petitioner did present certain other coupons which had been used to rent videos subsequent to the audit period (see, Finding of Fact "19"). As noted previously, however, very few of the coupons submitted bear any handwritten marking. This

⁵In this regard, it is noted that, the daily reconciliation sheets which were submitted herein are summarily rejected.

fact is, of course, inconsistent with Mr. Kanellopoulos' testimony regarding petitioner's procedure for coupon sales, and suggests that this procedure, even if accurately described, was rarely followed. Accordingly, petitioner's contentions regarding coupon sales are rejected.

I. Petitioner also contended that the total sales amounts for October 29 and 30, 1988 as used by the Division in its calculation of average daily sales improperly included the sales tax charged and collected by petitioner on those dates. Upon review of machine readings Z5617 and Z5824 (see, Finding of Fact "23"), both of which were reviewed by the Division on audit, and the Division's total sales figures for those two days (see, Finding of Fact "11"), it does appear that the Division's total sales figures for these two days improperly included sales tax. It is observed that the total sales amounts on readings Z5617 and Z5824 multiplied by 1.0825 (i.e. the prevailing sales tax rate) will result in the Division's total sales figure for these two days.⁶

J. With respect to the membership component of the assessment (see, Finding of Fact "14"), the record herein establishes that sales of memberships were rung up on petitioner's cash register. Consequently, the Division's determination of average daily rentals, calculated by using total sales as indicated by the four days of register tapes (see, Finding of Fact "11"), necessarily included any sales of memberships during the four-day observation period. In contrast, the Division's separate calculation of membership sales presumed that memberships were not rung up on the register. This calculation was therefore improper since the register tapes did include membership sales. The Division is therefore directed to modify its assessment by eliminating the membership fees component from the calculation of total additional taxable sales for the period June 1, 1987 through August 31, 1988. Using the Division's audit method, this modification will result in a margin of error equal to average daily sales (as determined pursuant to Conclusion of Law "G" herein) for the period June 1, 1987 through August 31, 1988 divided by reported taxable sales for the same period (see, Finding of Fact "15").

⁶It is noted that Conclusion of Law "G" makes this conclusion academic.

K. Tax Law § 1145(a)(1)(iii) provides for the remission of penalties where it is determined that the taxpayer's failure to pay the taxes due "was due to reasonable cause and not due to willful neglect." Petitioner contends that Mr. Peter Kanellopoulos' health problems led to petitioner's sales tax problems and that such health problems constitute reasonable cause for abatement of penalties. While Peter Kanellopoulos' health problems are not in dispute, there has been no showing that such problems caused or led to petitioner's sales tax problems. Specifically, petitioner's failure herein results primarily from its failure to maintain, during the period at issue, source documentation (e.g., cash register tapes) of individual sales as required under Tax Law § 1135. Failure to maintain such basic documentation and to make the records available for audit does not constitute reasonable cause or an absence of willful neglect for abatement of penalties (see, Matter of Lima Florists, Tax Appeals Tribunal, December 15, 1988). In the instant matter, there is no evidence that Peter Kanellopoulos' illness was in any way linked to petitioner's recordkeeping practices (see, Matter of Aberbach Enterprises, Ltd., Tax Appeals Tribunal, August 6, 1982). In other words, there is no evidence that petitioner would have maintained source documentation of its sales but for Peter Kanellopoulos or his illness. Accordingly, the penalties assessed against petitioner are properly sustained.

L. The petition of Taso's Video Fair, Inc. is granted to the extent indicated in Conclusions of Law "G", "I" and "J"; the petition is in all other respects denied. The Division is directed to modify the notice of determination dated May 30, 1989 in accordance with Conclusions of Law "G", "I" and "J"; as modified, the notice of determination is sustained.

DATED: Troy, New York

ADMINISTRATIVE LAW JUDGE